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In the Supreme Court of the United States

OCTOBER TERM, 1939

No. —

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

NORTHWEST STEEL ROLLING MILLS, INC.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

The Solicitor General, on behalf of Guy T. Helvering, Commissioner of Internal Revenue, prays that a writ of certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Ninth Circuit, entered in the above-entitled case on March 1, 1940, reversing the decision of the Board of Tax Appeals.

OPINIONS BELOW

The memorandum opinion of the Board of Tax Appeals (R. 14–18) is unreported. The opinions in the Circuit Court of Appeals (R. 77–85) are reported in 110 F. (2d) 286.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered March 1, 1940 (R. 85). The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

1. Whether, in computing its "undistributed net income" for purposes of the surtax on undistributed profits imposed by Section 14 of the Revenue Act of 1936, respondent, a Washington corporation, is entitled to credit under Section 26 (c) (1) of that Act on the ground that its charter and the state law constitute a written contract executed by the corporation, expressly dealing with and prohibiting payment of dividends during the taxable year 1936.

2. Whether respondent proved that, under state law, it could not legally pay dividends during the tax year.[1]

---

[1] These two questions are those decided adversely to the Government in the court below. Should the writ be granted, respondent will doubtless urge in support of the judgment below that the undistributed profits tax is unconstitutional, as here applied, because it allows a credit in the case of a written contract restricting the payment of dividends but not in the case of a similar oral contract. This contention was rejected by the court below and the decision in this respect is, we believe, plainly correct for the reasons set forth both in the majority and dissenting opinions (R. 79, 84–85).

STATUTES AND REGULATIONS INVOLVED

The statutes and regulations involved are set out in the Appendix, *infra*, pp. 10–19.

STATEMENT

The facts, as found by the Board of Tax Appeals (R. 14–15), may be summarized as follows:

Respondent is a corporation organized in 1926 under the laws of the State of Washington. Its principal place of business is Seattle, Washington. (R. 14.)

Respondent's surplus by appraisal at the beginning and end of 1936 was $134,173.90. Its operating deficit as of December 31, 1935, was $76,983.26, and its net income for the year ended December 31, 1936, was $76,049.71. (R. 14.)

From 1926 to 1936 respondent was indebted in considerable sums to the Seattle First National Bank. This indebtedness was evidenced by ninety-day notes which were renewed from time to time. In January 1934, when respondent proposed again to renew the notes, then aggregating approximately $115,000, the officer of the bank who was handling the matter told respondent's officers that a condition of renewal would be payment of $1,000 a month in reduction of the principal amount of the indebtedness, together with payments of any available surplus remaining in respondent's treasury after satisfaction of its current operating expenses. Respondent was given to understand that in case of a breach of this condition the bank would apply

for the appointment of a receiver. This condition to renewal of the notes was not reduced to writing and no written contract was ever executed by respondent which dealt with the payment of dividends. From January 1934 to July 1936, the amount of respondent's indebtedness to the bank was reduced to $85,000 and this amount was paid on July 6, 1936. (R. 14–15.)

In computing its surtax on undistributed profits, the respondent claimed a credit of $75,085.26 for contracts restricting dividend payments. The Commissioner disallowed the credit and determined a deficiency of $13,628.22 (R. 6–12). The action of the Commissioner was sustained by the Board (R. 18–19), but the court below reversed, one judge dissenting (R. 82).

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred:

(1) In holding that in the computation of its "undistributed net income" for purposes of the surtax imposed by Section 14 of the Revenue Act of 1936, respondent is entitled to a credit under Section 26 (c) (1) of that Act.

(2) In failing to hold that respondent is not entitled to such a credit because its corporate charter and the laws of the state of incorporation do not constitute a written contract executed by the corporation expressly dealing with and prohibiting the payment of dividends, within the meaning of Section 26 (c) (1).

(3) In failing to hold that respondent did not prove that it was prohibited under local law from paying dividends during the taxable year 1936.

(4) In reversing the decision of the Board of Tax Appeals.

REASONS FOR GRANTING THE WRIT

Under the laws of the State of Washington, a corporation is prohibited from paying dividends in cash or property except from surplus. Remington's Revised Statutes of Washington, Volume 5, Title 25, Sections 3803–24, *infra*, pp. 11–13. In the court below respondent contended that during the tax year 1936 it had no surplus within the definition of the Washington law and consequently that it could not legally have paid dividends. It urged that its charter and the laws of Washington constituted a "written contract executed by the corporation prior to May 1, 1936" expressly dealing with and prohibiting the payment of dividends, within the meaning of Section 26 (c) (1) of the Revenue Act of 1936, and that consequently it was entitled to the credit claimed. It further contended that unless a credit were allowed by reason of the prohibition against the payment of dividends imposed by Washington law, the undistributed profits tax, as applied to it, would be unconstitutional. And finally it contended that the tax was invalid because it permitted a credit in the case of a *written* contract restricting the payment of dividends and denied a credit in the case of an *oral* understanding

such as respondent's arrangement with the Seattle Bank. The Commissioner contended, on the other hand, that respondent's charter and the state law did not constitute a written contract executed by the corporation within the meaning of Section 26 (c) (1), that the Act so construed was constitutional, and that in any event respondent had failed to prove that its financial situation was such that state law prohibited it from paying dividends.

The court below, after expressing the opinion that the Act was not subject to attack because of the different treatment accorded oral and written contracts restricting the payment of dividends, held, one judge dissenting, that respondent's charter and state law constituted a written contract executed by the corporation within the meaning of Section 26 (c) (1), that the taxpayer had proved that, under state law, it could not legally have paid dividends during the tax year, and that consequently it was entitled to the credit claimed.

1. The decision of the court below that respondent's charter and the state law constituted a written contract executed by the corporation within the meaning of Section 26 (c) (1) is directly in conflict with the decision of the Circuit Court of Appeals for the Eighth Circuit in *Crane-Johnson Co.* v. *Commissioner,* 105 F. (2d) 740. The taxpayer's petition for certiorari in the *Crane-Johnson* case (No. 584, present Term) was denied on January 15, 1940 (308 U. S. 627), but on March 25, 1940, after the rendition of the decision in this case,

a petition for rehearing of the petition for certiorari in the *Crane-Johnson* case was granted, the order denying certiorari was vacated, and the petition for certiorari was granted. Every consideration compelling issuance of the writ in the *Crane-Johnson* case is equally applicable here.[2]

The desirability of having this case heard together with the *Crane-Johnson* case is emphasized by the fact that respondent's argument that the Act is unconstitutional because of the different treatment accorded oral and written contracts restricting the payment of dividends, is a contention not made by and not available to the petitioner in the *Crane-Johnson* case. It would be helpful in the administration of the revenue laws to have this question disposed of at the same time that the issues common to the two cases are decided.

---

[2] The question common to the instant case and the *Crane-Johnson* case has been decided in the Government's favor in the following additional cases: *Bastion Bros.* v. *McGowan*, 32 F. Supp. 93 (W. D. N. Y.), appeal to the Circuit Court of Appeals for the Second Circuit pending; *Utah Hotel Co.* v. *Hinckley* (D. Utah), decided January 29, 1940, not yet officially reported, but may be found in 1940 C. C. H., Vol. 4, par. 9342; *Cooperative Publishing Co.* v. *Commissioner*, 40 B. T. A. 465, appeal to the Circuit Court of Appeals for the Ninth Circuit pending; *McBrides, Inc.* v. *Commissioner* (B. T. A.), unreported memorandum opinion of June 20, 1939; *American Nat. Realty Co.* v. *Commissioner* (B. T. A.), unreported memorandum opinion of January 31, 1940; *Ingersoll Amusement Co.* v. *Commissioner* (B. T. A.), unreported memorandum opinion of January 31, 1940; *Clovis Hotel Co.* v. *Commissioner* (B. T. A.), unreported memorandum opinion of February 7, 1940.

2. A further question raised in this case is whether respondent has proved that, under state law, it could not have distributed by way of dividends any of the profits upon which the surtax was sought to be imposed. Cf. *Helvering* v. *Fitch,* No. 243, present Term; *Helvering* v. *Leonard,* No. 426, present Term. The mere fact that the taxpayer had an operating deficit at the close of 1935 does not compel the conclusion that it could not have declared dividends out of its net profits for 1936 so long as it had sufficient surplus, and the record does not disclose that it did not have such a surplus. See Remington's Revised Statutes of Washington, Vol. 5, Title 25, Secs. 3803–24 (pp. 11–13, *infra*); cf. *Jorguson* v. *Apex Gold Mines Co.,* 74 Wash. 243, 244, 245; *Goodnow* v. *American Writing Paper Co.,* 73 N. J. Eq. 692; *United Light & Power Co.* v. *Grand Rapids Trust Co.,* 85 F. (2d) 331, 336 (C. C. A. 6th), certiorari granted, 299 U. S. 534, dismissed per stipulation, 299 U. S. 618; Cook, *Corporations,* 8th Ed., Vol. II, Sec. 546, pp. 1905–1908. In overruling the Government's contention that the respondent had failed to prove the non-existence of a surplus, the court below relied upon the testimony of one of respondent's officers to the effect that the company had never been in a position to pay dividends so far as he knew (R. 50). This testimony, even though not objected to at the hearing, was a mere conclusion of law which does not constitute proof of the essential facts.

CONCLUSION

The judgment below is erroneous and conflicts with the *Crane-Johnson Co.* case, *supra,* in which the taxpayer's petition for certiorari has been granted. It is therefore respectfully submitted that this petition for a writ of certiorari should be granted.

FRANCIS BIDDLE,
Solicitor General.

MAY 1940.

APPENDIX

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 14. SURTAX ON UNDISTRIBUTED PROFITS.

(*a*) *Definitions.*—As used in this title—

* * * * *

(2) The term "undistributed net income" means the adjusted net income minus the sum of the dividends paid credit provided in section 27 and the credit provided in section 26 (c), relating to contracts restricting dividends.

* * * * *

SEC. 26. CREDITS OF CORPORATIONS.

In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—

* * * * *

(*c*) *Contracts Restricting Payment of Dividends.*

(1) *Prohibition on payment of dividends.*—An amount equal to the excess of the adjusted net income over the aggregate of the amounts which can be distributed within the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends. If a corporation would be entitled to a credit under this paragraph because of a contract provision and also to one or more credits because of other contract provisions, only the largest of such credits shall be allowed, and for such purpose if two or more credits are equal in amount only one shall be taken into account.

(2) *Disposition of profits of taxable year.*—An amount equal to the portion of the earnings and profits of the taxable year which is required (by a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the disposition of earnings and profits of the taxable year) to be paid within the taxable year in discharge of a debt, or to be irrevocably set aside within the taxable year for the discharge of a debt; to the extent that such amount has been so paid or set aside. For the purposes of this paragraph, a requirement to pay or set aside an amount equal to a percentage of earnings and profits shall be considered a requirement to pay or set aside such percentage of earnings and profits. As used in this paragraph, the word "debt" does not include a debt incurred after April 30, 1936.

(3) *Double credit not allowed.*—If both paragraph (1) and paragraph (2) apply, the one of such paragraphs which allows the greater credit shall be applied; and, if the credit allowable under each paragraph is the same, only one of such paragraphs shall be applied.

* * * * *

Remington's Revised Statutes of Washington, Vol. 5, Title 25, c. 1–A:

§ 3803–24. *Capital carried as liability—Computation—Dividends how paid.*

1. Every corporation shall carry upon its books as a liability the amount of its capital stock as defined in section 3803–1, subdivision 10.

2. Amounts of surplus arising from an unrealized appreciation or revaluation of

fixed assets shall be shown on the books of the corporation as a separate item apart from surplus profits or paid-in surplus.

3. In computing the aggregate of the assets of the corporation, the board of directors shall determine and make proper allowance for depreciation and depletion sustained, and losses of every character. Deferred assets and prepaid expenses shall be written off at least annually in proportion to their use as may be determined by the board of directors.

4. No corporation shall pay dividends,

a. in cash or property, except from the surplus of the aggregate of its assets over the aggregate of its liabilities, including in the latter the amount of its capital stock, after deducting from such aggregate of its assets the amount by which such aggregate was increased by unrealized appreciation in value or revaluation of fixed assets;

b. in shares of the corporation, except from the surplus of the aggregate of its assets over the aggregate of its liabilities, including in the latter the amount of its capital stock.

5. Cash dividends shall not be paid out of surplus due to or arising from,

a. any profit on treasury shares before resale; or

b. any unrealized profits due to increase in valuation of inventories before sale; or

c. the unaccrued portion of unrealized profits on notes, bonds, or obligations for the payment of money purchased or acquired at a discount unless such notes, bonds, or obligations are readily marketable, in which case they may be taken at their actual market value; or

d. the unaccrued or unearned portion of any unrealized profit in any form whatever,

whether in form of notes, bonds, obligations for the payment of money, installment sales, credits or otherwise.

6. Subject to the limitations contained in this section, a dividend may be declared in shares of the corporation whenever the board of directors so determine: *Provided,* That

a. if the dividend is to be paid in shares having a par value, the aggregate par value of such shares shall not exceed the amount of that portion of the corporation's surplus which is transferred to capital as payment for such shares;

b. if the dividend is paid in shares having no par value, the number of such shares may be fixed by the board of directors;

c. no dividend payable in shares of any class shall be paid to shareholders of any other class unless the articles so provide or such payment is authorized by the vote of the holders of a majority of the shares of the class in which the payment is to be made.

7. A corporation which owns wasting assets intended for sale in the ordinary course of business, such as mines, or oil or gas wells, or timber, or a corporation which owns property having a limited life, such as a lease for a term of years, or patents, need not deduct the depletion of such assets by sale or lapse of time in the computation of the fund available for dividends, and such a corporation may pay dividends from the net profits arising from its business without deduction of such depletion, subject, however, to the rights of the shareholders of different classes. [L. '33, p. 785, § 24.]

§ 3803–25. *Unlawful dividends.* If any dividend be paid in violation of section 3803–24, or if any other unlawful distri-

bution, payment or return of assets be made to shareholders,

1. The directors who knowingly, or without making reasonable inquiry, voted in favor thereof shall be jointly and severally liable to the corporation in an amount equal to the amount of the dividend so paid and the distribution, payment or return of assets so made;

2. Every shareholder who received any such dividend or any such distribution, payment or return of assets shall in the following instances be individually liable to the corporation in an amount equal to the amount so received by him:

a. when no director is liable to the corporation as provided in subdivision 1 of this section, or

b. to the extent that the corporation is unable to obtain satisfaction after judgments recovered against directors upon the liability imposed by subdivision 1 of this section.

3. No action shall be brought against a director under subdivision 1, or against a shareholder under subdivision 2

a. unless brought within two years from the date on which such payment, distribution or return was made; and no action shall be brought against a shareholder, under subdivision 2

b. unless brought within two years from the date of final judgment against the directors. [L. '33, p. 787, § 25.]

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

ART. 14–1. *Surtax on undistributed profits of corporations.*—In general, the Act imposes a surtax on the net income of corpora-

tions in an amount measured by the undistributed net income. The rates of surtax are graduated in brackets, the lowest rate being 7 percent of that portion of the undistributed net income not in excess of 10 percent of the adjusted net income and the highest rate being 27 percent of that portion of the undistributed net income which is in excess of 60 percent of the adjusted net income.

* * * * *

The undistributed net income is defined in section 14 (a) (2) as the adjusted net income minus the sum of (*a*) the dividends paid credit provided in section 27 (see articles 27 (a)–1 to 27 (h)–1, inclusive), and (*b*) the credit provided in section 26 (c), relating to contracts restricting the payment of dividends (see article 26–2).

* * * * *

ART. 26–2. *Credit in connection with contracts restricting payment of dividends.*— (*a*) The credit provided in section 26 (c) with respect to contracts restricting the payment of dividends is not available under every contract which might operate to restrict the payment of dividends, but only with respect to those provisions of written contracts executed by the corporation prior to May 1, 1936, which satisfy the conditions prescribed in the Act. The charter of a corporation does not constitute a written contract executed by the corporation within the meaning of section 26 (c). The provisions recognized by the Act are of two general types, as follows:

(1) Those which come within section 26 (c) (1), in that they prohibit or limit the payment of dividends during the taxable year; and

(2) Those which come within section 26 (c) (2), in that they require the payment, or irrevocable setting aside, within the taxable year, of a specified portion of the earnings or profits of the taxable year for the discharge of a debt incurred on or before April 30, 1936.

If a corporation is restricted with respect to the payment of dividends by two or more contract provisions coming within section 26 (c) (1), only the largest of the credits computed with respect to each of such provisions, and not their sum, shall be allowable under section 26 (c) (1) and, for such purpose, if two or more credits are equal in amount, only one shall be taken into account. However, section 26 (c) (3) provides that if both section 26 (c) (1) and section 26 (c) (2) apply, only the one of such paragraphs which allows the greater credit shall be applied, and, if the credit allowable under each paragraph is the same, only one of such paragraphs shall be applied.

(*b*) *Prohibition on payment of dividends.*—The credit provided in section 26 (c) (1) is allowable only with respect to a written contract executed by the corporation prior to May 1, 1936, which expressly deals with the payment of dividends and operates as a legal restriction upon the corporation as to the amounts which it can distribute within the taxable year as dividends. If an amount can be distributed within the taxable year as a dividend—

(1) in one form (as, for example, in stock or bonds of the corporation) without violating the provisions of a contract, but cannot be distributed within the taxable year as a dividend in another form (as, for example,

in cash) without violating such provisions, or

(2) at one time (as, for example, during the last half of the taxable year) without violating the provisions of a contract, but cannot be distributed as a dividend at another time within the taxable year (as, for example, during the first half of the taxable year) without violating such provision—then the amount is one which, under section 26 (c) (1), can be distributed within the taxable year as a dividend without violating such provisions.

The credit provided in section 26 (c) (1) is equal to the excess of the adjusted net income, as defined in section 14 (a), over the aggregate of the amounts which can be distributed within the taxable year without violating the provisions of such contract. The requirement that the provisions of the contract expressly deal with the payment of dividends is not met in case (1) a corporation is merely required to set aside periodically a sum to retire its bonds, or (2) the contract merely provides that while its bonds are outstanding the current assets shall not be reduced below a specified amount.

* * * * *

(c) *Disposition of profits of taxable year.*—Under the provisions of section 26 (c) (2), a corporation is allowed a credit in an amount equal to that portion of the earnings and profits of the taxable year which, by the terms of a written contract executed by the corporation prior to May 1, 1936, and expressly dealing with the disposition of the earnings and profits of the taxable year, it is required within the taxable year to pay in, or irrevocably to set aside for, the discharge of a debt incurred on or before April

30, 1936. The credit is limited to that amount which is actually so paid or irrevocably set aside during the taxable year pursuant to the requirements of such a contract.

Only a contractual provision which expressly deals with the disposition of the earnings and profits of the taxable year shall be recognized as a basis for the credit provided in section 26 (c) (2). A corporation having outstanding bonds is not entitled to a credit under a provision merely requiring it, for example, (1) to retire annually a certain percentage or amount of such bonds, (2) to maintain a sinking fund sufficient to retire all or a certain percentage of such bonds by maturity, (3) to pay into a sinking fund for the retirement of such bonds a specified amount per thousand feet of timber cut or per ton of coal mined, or (4) to pay into a sinking fund for the retirement of such bonds an amount equal to a certain percentage of gross sales or gross income. Such provisions do not expressly deal with the disposition of earnings and profits of the taxable year. A contractual provision, however, shall not be considered as not expressly dealing with the disposition of earnings and profits of the taxable year merely because it deals with such earnings and profits in terms of "net income," "net earnings," or "net profits."

The term "debt" as used in section 26 (c) (2) does not include an obligation of the corporation to a shareholder, as such, as distinguished from a creditor. Accordingly, amounts paid into, or set aside for, a sinking fund by a corporation for the retirement of preferred stock, pursuant to the terms of an agreement underlying the pre-

ferred stock issue, shall not be considered as set aside for discharge of a debt. An indebtedness evidenced by bonds or other similar obligations issued by a corporation is incurred as of the date such obligations are issued, and the amount of such indebtedness is the amount represented by the face value of the obligations. For the purpose of this article a bond or other similar obligation is not issued until it is executed and delivered to a person who holds it as a debt of the corporation. Bonds issued after April 30, 1936, in exchange in refunding a preexisting issue represent debts incurred after April 30, 1936, within the meaning of section 26 (c) (2).

U. S. GOVERNMENT PRINTING OFFICE: 1940